

# Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community May 2009

## SFAS 141R - Recognition and Measurement of Preexisting Relationships and Reacquired Assets

### Introduction

The Financial Accounting Standards Board (“FASB”) revised Statement of Financial Accounting Standards 141 (“SFAS 141R”), Business Combinations, in December 2007. Effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (January 1, 2009 for a calendar year company), SFAS 141R replaces existing Statement 141 in its entirety. SFAS 141R introduces the acquisition method of accounting and clarifies the treatment of specific assets and liabilities with respect to whether they should be included as part of acquisition accounting or treated as separate transactions outside the scope of the acquisition method. In this issue, we explore the application of these principles

to preexisting relationships between the seller and the buyer.

### Impact of SFAS 141R

SFAS 141R incorporates the concepts in EITF Issue No. 04-01, *Accounting for Preexisting Relationships between the Parties of a Business Combination* (“EITF 04-01”), which is nullified on the effective date of SFAS 141R. The treatment of preexisting relationships is now considered as part the recognition and measurement principles of SFAS 141R.

### Recognition

In the event of a business combination, the seller and the buyer may have a preexisting relationship before a transaction was contemplated or enter into an arrangement during negotiations that is separate from the business

combination. These situations may be contractual or non-contractual.

Under the recognition principle and the acquisition method, the **buyer** in a business combination can only recognize assets and liabilities that were exchanged in the business combination transactions rather than the result of a separate transaction. SFAS 141R provides guidance to assess the treatment of transactions representing preexisting relationships.

- If the transaction is entered into for the benefit of the buyer or combined enterprise, then it is likely to be a *separate transaction* and is accounted for in accordance with the relevant GAAP, not as part of applying the acquisition method. Specific examples of these transactions include the following:

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## SFAS 141R - Recognition and Measurement of Preexisting Relationships and Reacquired Assets (continued)

- The buyer and seller settle preexisting relationships.
  - Compensation is paid to the sellers or its employees for future services.
  - The sellers are reimbursed by the buyers for acquisition costs.
- If acquiring the preexisting relationship was for the benefit of the seller before the combination, then any or all amounts shall be included as a part of the assets acquired and liabilities assumed in the transaction and recognized as part of the acquisition method.

### Measurement

In the context of **settling a preexisting relationship** outside of the business combination, the buyer shall recognize a gain or loss for any preexisting non-contractual and contractual relationships based on the following:

- The gain or loss for a non-contractual preexisting relationship is measured at fair value.
- The gain or loss for preexisting contractual relationships are measured based on the lesser of: (i) unfavorable or favorable terms when compared with pricing for current

market transactions for similar items; and (ii) the amount of any settlement provisions in the contract. However, the amount of the gain or loss derived may be offset if the buyer had previously recognized a related asset or liability. With the exception of a reacquired right, the market component of a preexisting contract is not considered a separate, identifiable intangible asset, but is included in goodwill.

As revised in SFAS 141R, **reacquired rights** are considered identifiable intangible assets as they meet the contractual-legal and the separability criteria. A reacquired right is defined as a right that a buyer had previously granted to the seller to use the buyer's recognized or unrecognized intangible asset (e.g., franchise rights or technology license). However, the reacquired rights are recognized on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value. Furthermore, if the contract includes terms that are favorable or unfavorable, a gain or loss for the effective settlement of the contract is measured in accordance with the previously discussed preexisting relationship settlement provisions.

*Examples promulgated by FASB are outlined in the Statement.*



### About the author

**Mark Edwards**, Partner, Grant Thornton LLP, Economic Advisory Services — Valuation Services group  
T 704.632.6926 E Mark.Edwards@gt.com

Mark Edwards is a partner in the Economic Advisory Services practice of Grant Thornton LLP in Charlotte, North Carolina and leader of the Southeast Region Valuation practice.

Mark has been working in the valuation profession for more than 19 years and has worked with numerous public and private clients on financial reporting, litigation, transaction advisory services and strategic planning. In addition, Mark has been qualified as an expert witness and has provided testimony in matters where valuation is in dispute.

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### Valuation Services group contact information

<b>Neil Beaton</b> National partner-in-charge Seattle	206.398.2487
<b>Steven Krug</b> Atlanta	404.475.0041
<b>Mark Edwards</b> Charlotte	704.632.6926
<b>Massimo Messina</b> Chicago	312.602.8247
<b>Chuck Williams</b> Cincinnati	513.345.4542
<b>Todd Patrick</b> Dallas	214.283.8195
<b>Phil Gaglio</b> Detroit	248.213.4219
<b>Bryan Benoit</b> Houston	832.476.3620
<b>Edward Karstetter</b> Los Angeles	213.596.6762
<b>Venkat Komarlingam</b> McLean	703.847.7656
<b>Dean Polenz</b> Milwaukee	414.277.1512
<b>Mark Gehrig</b> Minneapolis	612.677.5139
<b>John Ferro</b> New York	212.542.9574
<b>Rich Hause</b> Philadelphia	215.814.4024
<b>Andrew Ross</b> San Francisco	415.365.5405
<b>Robert Duffy</b> Seattle	206.398.2479

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